Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FSH:HAR:TL-N-2962-01
CJSantaniello

date: MAY 09 2001

to: Chuck Stuart, Team Manager, LMSB, Group 1123, Hartford, CT
Attn: Jeff Rizzardi, Revenue Agent, Group 1541, Norwalk, CT

from: Associate Area Counsel, LMSB, Area 1

bject: **Large Case Advisory Opinion -** [redacted]

This memorandum responds to Revenue Agent Jeff Rizzardi's April 12, 2001 verbal request for assistance regarding the taxpayer's assertion that the Commissioner may not properly require the production of documents relating to tax years outside the audit cycle. This memorandum should not be cited as precedent.

We have reviewed the requests contained in I.D.R. 0142 and do not believe that any changes are warranted. You may, therefore, re-issue the I.D.R. with the anticipated 30-day response date. Additionally, as discussed below, we believe that because the I.D.R. is "necessary" and does not constitute an "inspection" of the taxpayer's books of account under section 7605(b), a summons issued for the same records would more than likely be enforced in an enforcement proceeding commenced in the United States District Court.

Issue

Whether an I.D.R. requesting documents pertaining to years subsequent to the current audit cycle constitutes an "inspection" of the taxpayer's books and records under I.R.C. § 7605(b), where the principle purpose of the request is to verify that the taxpayer has satisfied the "four of seven" indebtedness-to-premium requirement of I.R.C. § 264(c).[1/] **U.I.L Nos. 264.00-00; 7605.01-00**

Facts

During the examination of the taxpayer's [redacted] and [redacted] returns, the examination team determined that the taxpayer invested in Corporate Owned Life Insurance (COLI) policies. As a result of the taxpayer borrowing against the COLI policies, the taxpayer

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[1/] All statutory section references are to the Internal Revenue Code in effect during the taxable years at issue.

incurred significant interest deductions expenses, which the taxpayer deducted on the returns under examination.

To qualify for the deduction of interest paid with respect to COLI plans, taxpayers must not only satisfy the requirements of section 163 (i.e., that the amounts constitute interest paid or accrued on indebtedness), but also the requirements of section 264. Section 264(a)(3) denies a deduction for interest paid or accrued on debt as part of a pattern of borrowing on the cash surrender value of a life insurance policy. A pattern of borrowing is deemed to exist under section 264(c)(1) unless the taxpayer establishes that no part of four of the first seven years' annual premiums (or 4/7ths of the first seven years' total premiums) has been paid by means of indebtedness.

On [redacted], the examination team issued I.D.R. 0142, relating to the COLI issue. According to the revenue agent, this I.D.R. was prepared using language suggested by George Imwale, COLI ISP Coordinator.[2/] As specified in the I.D.R., it was issued as a follow-up to the taxpayer's response to I.D.R. 0071, also relating to the COLI issue. I.D.R. 0142 also contained the following language:

> You will note that several of the requests include information generated in years outside the current audit cycle. As demonstrated by the evidence cited and evaluated by the Tax Court throughout its recent opinion in Winn-Dixie v. Commissioner, 113 T.C. No. 21 (1999), information and documentation concerning COLI policy years beyond the tax years at issue are highly relevant when assessing the propriety of COLI interest deductions (and administrative fees) for federal income tax purposes.

It is evident from the Team Manager's note to the file dated March 28, 2001, that the examination team's request for information is intended to verify the section 264(c)(1) requirement that no part of the first seven years' annual premiums has been paid by means of indebtedness.

To date, the taxpayer has declined to comply with I.D.R. 0142 to the extent that the requested documents pertain to years outside the current audit cycle. By memorandum dated [redacted], the taxpayer stated its position that the requested information is irrelevant. Consequently, the examination team intends to reissue

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[2/] We have reviewed the requests contained in I.D.R. 0142 and do not believe that any changes are warranted.

I.D.R. 1042 with a 30-day deadline for returning the requested documents and, if necessary, issue a summons for those documents that are not produced.

Discussion

Section 7605(b) provides that "no taxpayer shall be subjected to unnecessary examinations or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary...notifies the taxpayer in writing that an additional inspection is necessary." IRS Policy Statement P-4-3 effectuates section 7605(b) by providing that the Service will not reopen any case closed after examination to make an adjustment unfavorable to the taxpayer unless one of several narrow criteria are met and the taxpayer is afforded notice of the reopening.

In analyzing whether a particular action on the part of the Service will serve to trigger the application of section 7605(b), it is important to bear in mind both the purpose of the statute and the general manner in which courts have interpreted it. As noted in United States v. Powell, 379 U.S. 48 (1964), section 7605(b) was enacted to prevent abuse and unnecessary inspections of a taxpayer's records by the tax collector. Accordingly, a common theme which runs through the cases construing section 7605(b) is the notion that the statute should be liberally construed to permit the Service to reasonably and effectively carry out its tax administration duties. Benjamin v. Commissioner, 66 T.C. 1084 (1976).

The courts have also emphasized that the statutory language "only one inspection of a taxpayer's books of account shall be made for the taxable year" must be read in *pari materia* with the first clause of the section: "no taxpayer shall be subjected to unnecessary examinations or investigations." (emphasis added) United States v. Schwartz, 469 F.2d 977, 983 (5th Cir. 1972). An investigation cannot be said to be "unnecessary" if it may contribute to the accomplishment of any of the purposes for which the Commissioner is authorized by statute to make inquiry. DeMasters v. Arend, 313 F.2d 79, 87 (9th Cir. 1963). A limited construction of section 7605(b) is also supported by the law's general antipathy toward the erection of barriers to ascertaining the truth, as well as the policy against judicial intervention in the investigative stage of tax matters because of the danger of undue delay in the collection of revenues. DeMasters, 313 F.2d at 87.

In light of these general principles, it is clear that the narrow inquiry in I.D.R. 0142 would not trigger the application of

section 7605(b). Initially, we note that the I.D.R.'s inquiry into the non-audit years is carefully limited to those items of information which bear directly on the question of whether the taxpayer has satisfied the section 264(c)(1) "four of seven rule" in order to qualify for claimed deductions of interest in the audit years. The Commissioner is clearly authorized by statute to make inquiry along these lines, since section 264(c) makes it clear that the taxpayer must satisfy the four of seven rule where, as here, there is symptomatic borrowing against policy cash value.

Additionally, we believe the requested records are germane to the larger issue of whether the claimed interest expenses satisfy the requirements of section 163. Formation of a sound judgment on the section 163 issue is heavily dependent on the examiner's analysis of actual plan transactions and financial performance. Accordingly, under the standards enunciated by the Ninth Circuit in DeMasters, we do not believe that the inspection can be deemed to be "unnecessary" within the purview of section 7605(b).

Furthermore, it is also important to recognize that section 7605(b)'s prohibition against second inspections does not apply unless the initial inspection was "meaningful". United States v. Garrett, 571 F.2d 1323, 1329 (5th Cir. 1978). See also United States v. Giordano, 419 F.2d 564 (8th Cir. 1970). The narrowly circumscribed request for documents appearing in I.D.R. 0142 certainly does not rise to this level. Consequently, we believe that I.D.R. 0142 could not reasonably be construed as an "inspection" of the taxpayer's books and records for the years outside the current audit cycle.

Conclusion

Section 7605(b) was intended to impose restraints on overzealous revenue agents and to prevent needless or harassing inspections of taxpayer books and records. I.D.R. 0142, rather than failing within this category, represents a carefully tailored inquiry into a narrow class of subsequent year taxpayer records that are essential to the Commissioner's determination as to whether the taxpayer's claimed interest costs are deductible under sections 163 and 264. As such, the I.D.R. is "necessary", and does not constitute an "inspection" of the taxpayer's books of account under section 7605(b). Any other interpretation would only serve to frustrate the Commissioner's legitimate efforts to discharge his statutory duties.

We are simultaneously submitting this memorandum to the National Office for post-review and any guidance they may deem appropriate. Consequently, you should not take any action based on the advice contained herein during the 10-day review period. We

will inform you of any modification or suggestions, and, if necessary, we will send you a supplemental memorandum incorporating any such recommendation.

Since there is no further action required by this office, we will close our file in this matter ten days from the issuance of this memorandum or upon our receipt of written advice from the National Office, whichever occurs later. Please call Carmino J. Santaniello at (860) 290-4075 if you have any questions or require further assistance.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

BRADFORD A. JOHNSON
Associate Area Counsel
LMSB, Area 1

By: (Signed) Carmino J. Santaniello
CARMINO J. SANTANIELLO
Attorney